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In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 780

THE FRANKLIN LIFE INSURANCE COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW AND JURISDICTION

The opinion below and the basis of this Court's jurisdiction are adequately described in the petition (pp. 1–2).

QUESTIONS PRESENTED

1. Whether, in determining the income of a life insurance company, the total amount of deferred and uncollected premiums must be included in its "gross amount of premiums" under Section 809(c)(1) of the Internal Revenue Code without the offset petitioner claims for an amount it calls "increase in loading on deferred and uncollected premiums."

2. Whether a life insurance company must include the total amount of deferred and uncollected premiums as assets under Section 805(b)(4) without the adjustment it claims for an amount it calls "loading on deferred and uncollected premiums."

3. Whether a life insurance company, in computing its "taxable investment income," must include the full amount of prepaid interest received during the taxable year and held by the company under claim of right at the end of that taxable year.

4. Whether a life insurance company must include in its assets under Section 805(b)(4) amounts representing unpaid interest that has been capitalized as an addition to the principal amount of such loans.

STATUTE AND REGULATIONS INVOLVED

The relevant provisions of the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959, are adequately set forth in the petition (pp. 3, 51a–78a).

Pertinent provisions of the Treasury Regulations, other than those set forth in the petition (pp. 3, 78a–82a), are reproduced in the appendix to this brief, pp. 24–25, *infra*.

STATEMENT

Petitioner raises four legal issues relating to the determination of a life insurance company's tax liability under the Life Insurance Company Income Tax Act of 1959 (Section 801 through 820, or Part I of Subchapter L, of the Internal Revenue Code of 1954, as amended). The Act provides that the taxable income of a life insurance company includes the full amount

of its "gain from operations" up to the amount of its "taxable investment income," plus one-half of any additional "gain from operations" (Section 802(b)). "Taxable investment income" and "gain from operations" are each the result of detailed calculations and are defined in Sections 804(a) and 809(b), respectively.[1]

In petitioner's timely suit for refund in the United States District Court for the Southern District of Illinois, the court sustained petitioner's contentions in all respects. On the government's appeal, the Seventh Circuit reversed on all issues.

1. DEFERRED AND UNCOLLECTED PREMIUMS

In determining the income tax of a life insurance company, the calculation of "gain from operations" and of "taxable investment income" requires a determination of a life insurance company's "gross amount of premiums" during the taxable year. In calculating "gain from operations," the gross premiums constitute part of the basic figure—*i.e.*, that comparable to "gross receipts" or "gross income"—from which "gain from operations" is computed by subtracting statutorily defined deductions. In determining "taxable investment income," the gross premiums are included in the company's "assets," which control the fraction of investment income that is deemed "taxable".

The "gross annual premium" on a life insurance contract is the consideration the insured pays for a

[1] A description of the calculations performed in computing tax liability under the Act is contained in *United States* v. *Atlas Ins. Co.*, 381 U.S. 233.

year's coverage; each premium covers an annual period beginning on the date of issuance or a subsequent anniversary date. The "net valuation premium" is the part of the "gross annual premium", computed on the basis of State required interest and mortality tables, that must be added to reserves for policyholders in each policy year. The district court defined the difference between the "gross annual premium" and the "net annual valuation premium" as the "loading" (Pet. 31a).[2] It further found that the "loading" does not represent a deduction for anticipated future expenses (Pet. 39a).

Deferred and uncollected premiums are portions of gross annual premiums on policies in force at the end of the taxable year which have not been collected, either because the gross annual premium is being paid in installments over the policy year or the premium is due but unpaid (a grace period having been provided in the policy). (Pet. 32a–33a.) Where payment of part of the premium has been deferred, the premium is increased by an amount designed to compensate petitioner for the loss of interest on the deferred portion of the premium, for the added cost of servicing the account, and for the risk that the insured will die during the policy year while part of the premiums remain deferred and uncollected.[3] If the insured dies at a time when the premium is due but unpaid--i.e., during the grace

[2] "R." references are to appellant's (respondent here) Appendix B in the court of appeals. "Pet." refers to the Petition For A Writ of Certiorari and appendix thereto.

[3] Prior to 1950, unpaid portions of the deferred premiums would be deducted from the policy benefits if the insured died during the policy year (R. 135).

period provided in the policy—the unpaid portion of the premium is deducted from the amounts due the beneficiaries.

Petitioner accrues its reserves on the basis of the assumption that the *full* annual premium is received on the anniversary date of every policy in force, whether or not the full premium has been paid as of that date. (Pet. 40a.) This method of calculating reserves has a three-fold effect in decreasing petitioner's tax base: (1) It increases the reserves which petitioner is entitled to deduct under Section 809(d)(2) in calculating gain from operations; (2) by reason of Section 809(a)(2), it increases the fraction of investment income that is excluded from tax under Section 809(a)(1); and (3) it increases the reserves used in determining the policyholders' share of investment income, which under Section 804(a)(1), is also excluded from tax.

The Treasury Regulations, Sections 1.805–5(a)(4)(ii) (Example 1)[4] and 1.809–4(a)(1)(i),[5]

[4] "Sec. 1.805–5 *Adjusted reserves rate and earnings rates.*

"(a) *In General.* * * *

* * * * *

"(4) *Assets*—* * *

"(ii) *Illustration of principles.* * * *

"*Example* (1). Included in the statement of assets of P, a life insurance company, are the following items: Bonds, stocks, mortgages, home office and branch office buildings owned and wholly occupied by the company, furniture and equipment owned by the company and used in the home office and branch office buildings occupied by the company, agents' debit balances, *premiums deferred and uncollected and premiums due and unpaid*, bank deposits (including time deposits), and share accounts in savings and loan associations." (Emphasis added in Example.)

[5] "Sec. 1.809—4 *Gross amount.*

"(a) *Items taken into account.* For purposes of determining gain or loss from operations under section 809(b) (1) and (2),

expressly require the inclusion of deferred and uncollected portions of premiums in the calculation of both gross premiums and assets. Petitioner does not disagree with this requirement but claims an adjustment—*i.e.*, a deduction or exclusion—for an amount called "loading" in determining its "gross amount of premiums" under Section 809(c)(1) and its "assets" under Section 805(b)(4). Essentially, petitioner would calculate its net valuation premium (*i.e.*, the addition to reserves), subtract that from the gross annual premium, label the remainder "loading", and offset against the gross premiums the part of "loading" petitioner deems allocable to the deferred part of the premium. The end result is to include only the portion of the gross premium that has in fact been paid plus the part of the deferred portion that is included in reserves.[6]

The court of appeals, reversing the district court's approval of petitioner's contentions, refused to (Pet.

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respectively, section 809(c) specifies three categories of items which shall be taken into account. * * * The * * * three * * * items taken into account are: (1) *Premiums.* * * * The term "gross amount of all premiums" means the premiums and other consideration provided in the insurance or annuity contract. * * * *Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid*, * * *." (Emphasis added in last sentence.)

[6] Petitioner follows the treatment provided on the annual statement form of the National Association of Insurance Commissioners, which petitioner must file annually in the States where it does business. (R. 75, 177–178, 321–324, 328–334). The annual state-

8a–9a) "attribute to Congress an intention that in the same statutory equations, exclusions and deductions attributable to reserves are to be based on the assumption that the annual premium is fully paid up and yet the amounts in the same equation from which these figures are to be subtracted are to be determined on the assumption that the annual premium is not fully paid up." It concluded that (*id.*, 9a) "The gearing of the tax statute to an annual reserve requires recognition of no less than the annual premium."

2. INTEREST COLLECTED IN ADVANCE AND CAPITALIZED INTEREST

All of petitioner's life insurance policies and annuity contracts having cash values provide that a loan may be obtained on the sole security of the policy whenever a cash value is available and the policy is in force. Interest on policy loans is payable in advance. At the time the loan is made, the interest to the end of the current policy year is deducted from the principal loaned to the policyholder, and a year's interest is due annually thereafter on each policy anniversary date. If an ensuing year's

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ment form is intended to demonstrate the solvency of the company using purposefully stringent and conservative accounting standards, designed to show an assumed net worth upon liquidation of the company (R. 177–178, 328–330, 334; Pet. 5a, 9a.) Although petitioner relied upon the NAIC form below, and the petition is replete with references to the form, petitioner apparently no longer contends that the NAIC form is binding for Federal tax purposes.

interest is not prepaid on that date, and the available cash value equals or exceeds the unpaid interest, the latter is "capitalized"—*i.e.*, it is added to principal to the extent of the remaining cash value. (R. 88.)

Although there is no due date for repayment of the loans, policy loans may be repaid in whole or in part at any time. Upon such a repayment during the policy year, a pro rata portion of the interest is refunded. If the borrower surrenders his policy for the remaining cash value or dies during the year, only that ratable portion of the interest considered "earned" is retained—the remainder is repaid to the borrower or his beneficiary. (R. 88.)

The district court rejected the government's position that prepaid interest must be taken into investment income when received and unpaid interest added to assets when capitalized. Instead, it agreed with petitioner's claim that it need reflect as income only that portion of the prepaid interest which it describes as ratably "earned" during the tax year and that it similarly need include in assets only what it describes as the ratably "earned" amount of capitalized unpaid interest.[7] The court of appeals reversed, first because the prepaid interest was received and held without any restriction on its use, and also because the government's position was considered to be a proper exercise by the Commissioner of Internal Revenue of his authority to require that methods of

[7] Petitioner (Pet. 13a) introduced no evidence as to the amount, if any, of refunds of prepaid interest it was required to make from year to year; it only estimated the "unearned" interest for four of the taxable years involved (R. 270–271, 274, 284–285).

tax accounting "clearly reflect income" (26 U.S.C. 446 (b)) (Pet. 12a–13a).

ARGUMENT

1. DEFERRED AND UNCOLLECTED PREMIUMS

(a) Contrary to the impression that petitioner and the *amicus curiae* each attempt to give, they neither rely on nor wish to have applied what they call (Pet. 13) "settled principles of tax accrual accounting". Indeed, it is quite clear that they would strenuously object to an across the board application of their concept of accrual principles. The basis for petitioner's argument that the deferred and uncollected premiums should not be reflected in its tax base is its claim that it has no right to compel payment of these portions of the gross premium. But if that were to be the keystone to accounting under the 1959 Act, the amount of reserves an insurance company could claim would then be reduced by the amount of reserves attributable to deferred and uncollected premiums,[8] thereby increasing gain from operations and the taxable investment income. This is an outcome that petitioner in fact opposed in its brief below (at pp. 57–58).[9]

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[8] Thus the Treasury Regulations require "appropriate reduction * * * in the life insurance reserves" if "it is determined on the basis of the facts of a particular case that premiums deferred and uncollected and premiums due and unpaid are not properly accruable for the taxable year". Treas. Reg. Section 1.801–4(f).

[9] The record does not show the net effect on petitioner's tax liability of decreasing both its reserves and its gross premiums by the amount allocable to deferred uncollected premiums unpaid at the end of each taxable year in issue here.

The proper way to approach the treatment of deferred and uncollected premiums is to determine first what Congress meant in its reference to "the gross amount of premiums" in Section 809(c)(1). Although the statute does not further define this phrase, Congress, as the court of appeals recognized, was fully familiar with the accounting practices used in the insurance industry and it must therefore be assumed that Congress was aware that life insurance companies, in accounting for their gross premiums, accrue the full year's premium as of the anniversary date of each policy.[10] The only logical inference is that Congress thought the same assumption would be made in defining the phrase "gross amount of premiums" it used in the statute.

Indeed, we do not understand the petitioner or the *amicus* to argue otherwise. Rather in its court of appeals brief petitioner expressly stated (p. 44) "the intent and purpose of the Life Insurance Company Income Tax Act of 1959 require that the deferred and uncollected premiums be included in income on a gross basis (which includes loading)—and that is what this regulation provides." Thus, petitioner includes the deferred portion of premiums in its "gross" but then claims an "offset"—in substance an exclusion or a deduction—for so much of the deferred and uncollected premiums as exceed the part of such premiums it seeks to use—as "reserves"—to decrease its tax liability.

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[10] Petitioner's witnesses referred to this accrual as being based on a "fictional" assumption. (R. 132.)

The initial defect in this contention is that Congress has not provided for such an exemption or deduction. Although subchapter L of the code is filled with detailed provisions which define a number of allowable exclusions and deductions in the computation of the income tax liabilities of life insurance companies, not one refers, directly or indirectly, to "loading" or "increase in loading." It is no less true here than in any other tax case that exclusions and deductions must have an explicit statutory basis, and, as the court of appeals recognized here (Pet. 7a), the absence of such a statutory provision is fatal to petitioner's claim.

The second defect is found in petitioner's repeated attempts to give the impression that the offset it claims is but a reflection of items, like agents' commissions, that in any event would later become deductible. The district court expressly found, pursuant to petitioner's request, that the sought-for "loading" deduction did not represent estimates of anticipated expenses. Moreover, as Congress was fully aware, see S. Rep., No. 291, 86th Cong., 1st Sess., pp. 6–7, "loading" also includes whatever profits petitioner might realize from the particular gross premium.

Indeed the effect of petitioner's claimed offset would be to defer tax indefinitely on part of its first year's profit on policies having deferred premiums. In the first policy year petitioner would take deductions for all expenses incurred during the taxable year, a full year's reserve on the policy, and the loading deduction claimed here. In later taxable years, the first year's loading deduction would not be recovered into income, for loading on the deferred and uncollected

portion of the premium would remain constant and petitioner would deduct expenses in fact incurred in succeeding years. "The only point at which the additional deduction would be recovered for tax purposes would be in the last year of the policy, or in the event the terms were changed so as to provide for no more deferred payments; * * *. [I]n the case of a stable or growing company, such overall deductions would not be recovered for tax purposes * * * until some indefinite time in the future." *Jefferson Standard Life Ins. Co.* v. *United States,* 272 F. Supp. 97, 115 (M.D.N.C.), appeal pending (C.A. 4).

The defects in petitioner's position are even more apparent with respect to the determination of its assets than in the case of its "gain from operations." It is an elementary principle of accrual accounting that assets and liabilities must be related in point of time. (R. 333) For example, it is established that a taxpayer who accrues the cost of goods sold must also accrue in his income the full amount of the receivables attributable to the sales even if payment has in fact not been made. See *Charles C. Lewis Co.* v. *United States,* 14 F. Supp. 471 (D. Mass.). Here, contrary to that rule, petitioner would accrue as a liability the full annual reserve for insurance coverage but then not show as an asset the full amount of the annual premium which gives rise to the liability.

The only support for petitioner's claim is that the treatment urged is allowed for NAIC annual statement purposes. That form, however, was designed to show the financial strength of a life insurance company using stringent and purposefully conservative

standards for the purpose of demonstrating the company's strength upon liquidation. That purpose requires a minimization of income and assets, an objective entirely alien to the function of the income tax laws.[11]

Furthermore, the NAIC approach, in line with its basic objective, shows the greatest possible liabilities on the reserve side, while reflecting only the amount of deferred and uncollected premiums equal to the reserves included with respect to those premiums. This case, however, is concerned with a tax formula which relies upon the proportionate relationship between assets and reserves in determining the amount of investment income that is to be excluded from petitioner's tax base. For these purposes, as the court of appeals said (Pet. 9a), petitioner cannot use "an admittedly overstated reserve while at the same time allowing an accounting entry with respect to assets which, while compensating *numerically* for the overstatement, does not fully account for the related asset * * *." (Emphasis original.)

Nor can the reference in Section 818(a) of the Code to the NAIC form provide the blanket adoption of NAIC accounting necessary to sustain petitioner's claim. The comprehensive detailed tax formulae set

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[11] The life insurance industry's own Joint Committee on Blanks of the American Life Convention and the Life Insurance Association of America agreed in 1963 that the basic objectives of the annual statement are so different in concept as to preclude the revision of the annual statement blank to conform to tax accounting concepts. (R. 329–330.) II Proceedings of the National Association of Insurance Commissioners (1963), pp. 445–447.

out in the substantive sections of Subchapter L belie any assumption that Congress merely sought to adopt the NAIC form *in toto* into the taxing statute.

Moreover, the legislative history of the Act makes clear that the NAIC form may only be used when "not inconsistent with the provision of the 1954 Code and an accrual method of accounting." H. Rep. No. 34, 86th Cong., 1st Sess., p. 42. Not only does Subchapter L fail to provide a deduction or exclusion with respect to loading, but such an adjustment would indefinitely defer tax on part of petitioner's income and would allow deductions for expenses that have not been incurred. And petitioner's method may not properly be called an accrual method of accounting, for it would accrue the deferred and uncollected premiums for purposes of determining deductible and excludable reserves, but would not allow the accrual for the rest of the equation that determines petitioner's overall tax situation.[12]

(b) Petitioner cannot seriously argue (Pet. 13–14), as it has attempted only since the decision below,

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[12] Although petitioner and the *amicus* attack our position as an attempt to include in income amounts that petitioner has no right to receive or may never receive, the record shows that petitioner receives 95 to 98% of the deferred and uncollected permiums in the regular course. (R. 334) In the remainder of situations, petitioner is equally well covered. When the premium is overdue and unpaid, petitioner either cancels the policy, or, if death occurs during the grace period, deducts the unpaid premium from the policy benefits. When payment of the premium has been deferred to a semi-annual, quarterly, or monthly basis, petitioner receives a premium larger than the annual premium, and the addition, *inter alia*, covers the risk that the policyholder will die before completing payments on that year's premium (see pp. 4–5 *supra*).

that constitutional limits on the income tax power require the offset it claims. This Court has on a number of occasions made clear that Congress constitutionally may require the recognition of certain items of income as a condition for the allowance of deductions conferred as a matter of legislative grace. For example, in *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371, a life insurance company was required to include in gross income the net rental value of that portion of a building which it occupied as a condition to taking depreciation and other income tax deductions on the entire building.

More recently, in *United States* v. *Atlas Ins. Co.*, 381 U.S. 233, this Court rejected a claim that a life insurance company's tax exempt interest (as from municipal bonds) should be attributed in its entirety to the taxable rather than nontaxable portions of the company's income; the rationale of the taxpayer's argument was that an allocation of the tax exempt items would indirectly tax income that is statutorily exempt. See 381 U.S. at 236–239. Citing *Helvering* v. *Independent Life Ins. Co., supra,* the Court took the opportunity to "affirm the principle * * * that the tax laws may require tax-exempt income to pay its own way" and to state its view that "Congress has done no more * * * than to particularize this principle in connection with taxing the income of life insurance companies." (381 U.S. at 247.)

Here petitioner and the industry generally are content to compute reserves and reduce tax liabilities on the basis of an accrual of the full premium

on every policy as of the anniversary date. No constitutional barrier prevents the requirement that the same accrual control the statutorily required additions to income.

(c) The decision of the court of appeals in this case is the first appellate test of the deferred and uncollected premium issues, and the only other district court to pass upon the issues also agreed with the government's contentions, *Jefferson Standard Life Insurance Co. v. United States, supra*.[11] Accordingly there is no conflict of judicial decision which independently justifies a grant of certiorari.

To be sure, petitioner asserts (Pet. 19) a "flat conflict" with the decision of the Tax Court in *Western National Life Ins. Co. v. Commissioner*, 50 T.C. No. 28. But petitioner has neglected to add that the case does not support its position here and in fact remains open on the Commissioner's petition for reconsideration. The initial holding in *Western National* was that deferred and uncollected premiums are to be excluded entirely from the Section 805 computation of assets—the position that petitioner expressly disclaimed below and a conclusion that would require a reduction in the allowable reserves (Tr. 70–71).[12] After the Commissioner moved for reconsideration on May 31, 1968, maintaining the position taken by the government in this case, the Tax Court invited the *amicus* here to submit a brief setting forth the industry position. In that brief and in the argument before the

[11] This case is on appeal to the Fourth Circuit, and was argued and submitted on October 30, 1968.

[12] See p. 10, *supra*.

Tax Court on August 7, 1968, the amicus asserted that the decision was wrong and that the Tax Court should adopt the position petitioner takes here."

Although we believe that petitioner has grossly exaggerated the revenue consequences of the decision below,[11] we agree that it is an industry-wide issue and has significant monetary importance.[12] We would therefore not oppose certiorari even in the absence of

[11] As of this writing no decision or other action has been taken, and the Commissioner's motion remains pending after oral argument.

[12] Illustrative of petitioner's method for demonstrating that "the figures are of staggering size", the loading on deferred and uncollected premiums as of December 31, 1960, is estimated to be $850,000,000. (Pet. 23.) But this figure affects only the assets, and it is a rather small part of all life insurance assets. The assets total is used only in the determination of a "current earnings rate" under Section 805(b)(2), which then becomes one of the determining factors in computing the excluded "policyholder's share" of taxable investment income.

[13] Best available Treasury estimates are that the current deferred and uncollected premium issues involve approximately $9,000,000 annually and that the total amount involved for the eleven year period 1958–1968 approximates $70,000,000. This estimate was obtained by computing the increase in tax attributable to the deferred and uncollected premium issues for the ten largest life insurance companies (seven mutuals and three stock companies) for the period 1958–1963. The average tax increase of 9% was then projected through estimated taxable income of the entire industry for the period 1958–1968. The Treasury's computation in *United States* v. *Atlas Ins. Co.*, *supra*, where the petition was granted in the absence of conflict upon a showing that at least a "quasi-constitutional" issue was presented, showed that 8,000 claims involving $100,000,000 were then at stake, and that the estimated annual projection of the revenue involved for future years ranged from $77,000,000 to $325,000,000. (Petition for a Writ of Certiorari, No. 189, October Term, 1964, pp. 15–17.)

a conflict if it appeared that present review would facilitate the final settlement of the income tax liabilities of this and other life insurance companies. But review would not dispose of those cases, since they involve other important questions of statutory construction—most of them industry-wide issues involving substantial amounts—as well as the deferred and uncollected premiums issue." In addition, a grant of certiorari here well might freeze those cases in their present status and further postpone the date on which audits of the life insurance companies may be closed.

Here, moreover, petitioner expressly disclaimed in the lower courts an issue that it seems to argue in its petition—the claim that accrual principles require the full exclusion of deferred and uncollected premiums from the income tax computation. And the finding that the "loading" that is the keystone of the sought-for offset does not even represent an estimate of anticipated expenses suggests that review on this record would be particularly inappropriate.

" For example, the appeal and cross-appeal of *Jefferson Standard Life Ins. Co. v. United States*, *supra*, argued and submitted to the Fourth Circuit on October 30, 1968, involves not only three of the four issues here but seven other issues of first impression under the 1959 Act. Similarly, *Occidental Life Insurance Co. of California* v. *United States* (C.D. Calif., Civ. No. 66-273 F) involves not only the deferred and uncollected premium issues but also four other issues of first impression. *Western National Life Ins. Co.* v. *Commissioner*, 50 T.C. No. 28, *supra*, still open on the Commissioner's motion for reconsideration, involves at least two other important issues besides deferred and uncollected premium issues.

2. PREPAID AND CAPITALIZED INTEREST

(a) Petitioner requires borrowers to prepay a year's interest on loans made against the cash value of the policies. If the advance interest has not been paid on the anniversary date of the policy, and the available cash value exceeds the unpaid interest, petitioner capitalizes that interest by adding it to the principal of the policy loan.

Although a ratable refund of prepaid interest is made if part or all of the principal is repaid during the policy year, the loans have no due date and petitioner has no fixed or even predictable future liability to repay the prepaid interest. Thus the interest which petitioner collects in advance belongs to it with no restriction whatsoever as to its use, and, under settled principles, those amounts must be included in taxable investment income. For an accrual basis taxpayer must report in full amounts actually received by it under a claim of right during the taxable year, and this is so even when portions of those amounts represent payment for services rendered in a subsequent year (*Schlude* v. *Commissioner*, 372 U.S. 128) and despite the fact that taxpayer later may be required to refund some of the money (*North American Oil* v. *Burnet*, 286 U.S. 417).

Similarly, there is no reason to omit any part of the capitalized interest in computing the "assets" of petitioner. These amounts earn additional interest for petitioner throughout the taxable year, just as does

the principal amount of any loan petitioner has made. When these amounts are added to the loan principal, they reduce the amount petitioner would pay the insured upon either death or surrender of the policy. Since the transaction thereby reduces the liability side of petitioner's ledger, the result is the same as though the borrower had paid the interest in cash. The fact that some part of that interest might have to be returned if the borrower pays up the loan in the following year is immaterial in the case of an accrual basis taxpayer for the reasons already discussed in respect to interest collected in advance. Significantly, even the NAIC annual statement form (on which petitioner seeks to rely in connection with other issues) requires that the entire amount of interest capitalized during the year be reflected as assets of the life insurance companies. (R. 293–294, 296.)"

(b) As in the case of the issues relating to deferred and uncollected premiums, the court of appeals decision here is the first appellate expression on point.[19] Again, the only other district court to pass upon these issues reached the identical result, *Jefferson Standard Life Ins. Co. v. United States, supra.*

There is not, as petitioner urges (Pet. 32), an intra-circuit conflict between the decision here and the de-

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[18] Although petitioner maintains that its position is consistent with the NAIC forms in respect to both prepaid interest and capitalized interest (Pet. 11), its explanation of why that is so is limited to description of the Exhibits to the form relating to income only—the schedule of assets is not discussed (Pet. 11 n. 2).

[19] The opinion is in accord with Rev. Rul. 58-225, 1958-1 Cum. Bull. 258.

vision in *Artnell Co.* v. *Commissioner*, 400 F. 2d 981 (C.A. 7). *Artnell* arose because a corporate reorganization and liquidation terminated the taxable year of the Chicago White Sox baseball team. The issue was whether the liquidated corporation should be required to report sales of tickets and other prepaid revenues related to future games when the later games were to be played by the successor corporation. Petitioner entirely fails to recognize that the Seventh Circuit did *not* hold that deferral of the prepaid income was proper. It merely remanded for further inquiry into the question whether (*id.*, 984) "the extent and time of future performance are so certain, and related items properly accounted for with such clarity, that a system of accounting involving deferral of prepaid income is found clearly to reflect income * * *". And this result must be viewed in the light of the peculiar fact that holders of tickets to unplayed games could secure refunds merely by demand.

In our view, *Artnell* was wrongly decided and reflects an improvident reading of the Commissioner's authority to determine whether a method of accounting clearly reflects income. See 26 U.S.C. 446; compare *Schlude* v. *Commissioner*, *supra*; *American Automobile Ass'n.* v. *United States*, 367 U.S. 687. There is not, however, a conflict, for there are multiple bases on which the two cases may be distinguished. For example, this case does not involve dual taxpayers or a pretermitted taxable year, and the contingencies that might cause restoration of the prepaid amounts are substantially different in nature.

The rule of *Artwell* will indeed not be entirely clear until the court of appeals has a further opportunity to consider the *Nebbia* rule in the light of whatever evidence is adduced upon remand to the Tax Court. Thus, it is particularly noteworthy that the *Artwell* opinion does not even refer to the opinion here."

(c) Although petitioner cites seemingly large dollar figures as the amounts of interest at issue on an industry-wide basis, it entirely neglects to translate its data into tax consequences. Assuming, for the moment, the accuracy of petitioner's claim (Pet. 35) that $35,000,000 in interest is involved, that gross amount must be reduced first to reflect the excluded "policyholder's share" (usually 75 per cent or more) of taxable investment income and then multiplied by the effective corporate income tax rate. The tax result would be less than 48 per cent of less than 25 per cent of $35,000,000—around $4,000,000 annually. There is, moreover, another inflationary element in petitioner's

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[1] There is no substance to the claim (Pet. 30-31) that the decision here is inconsistent with *Gunderson Bros. Engineering Corp.* v. *Commissioner*, 42 T.C. 419, and *Lukens Motor Co.* v. *Commissioner*, 42 T.C. 732. As the court below observed (Pet. 13a) those cases "did not involve amounts actually received by the taxpayers by way of prepayment."

There is a similar defect in petitioner's claim of a "completely baseless discrimination" between banks and life insurance companies (Pet. 36). Notably the only Internal Revenue Service publication relied on (Pet. 31 n.1), S.M. 3820, IV-2 Cum. Bull. 32 (1925), did not deal with interest actually received but with interest which was not to be received by the bank until the maturity of the notes in later years. Thus, it was not a situation, such as here, where the lender had the interest in hand, through either prepayment or as a charge against the cash value of an insurance policy which it already held.

estimate. Its source is NAIC Form, Exhibit 3, line 5, column 7, which includes "interest on premium notes, policy loans and liens" (Pet. 35, fn. 5), and petitioner has made no effort to sift out the interest on policy loans from that total."

In the final analysis, the interest issues are unworthy of further review in the absence of a conflict.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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"A Treasury analysis of the returns of the ten largest life insurance companies (seven mutuals and three stock companies), which account for 55 percent to 60 percent of the total income taxes paid by the life insurance industry, discloses that four have adopted the practice of banks making loans to depositors and do not collect interest in advance on policy loans. (See p. 22, n. 21, *supra*.) The total amount of prepaid interest was less than $2,000,000 for the entire period 1958–1965, most of which was accounted for by two companies. The tax consequences are even less, since the $2,000,000 must be broken down into annual figures, the greater part excluded as the "policyholders' share" of investment income, and the 48 percent tax rate applied against the balance.

APPENDIX

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.801–4. *Life insurance reserves.*

* * *

(f) ***Adjustments to life insurance reserves.*** In the event it is determined on the basis of the facts of a particular case that premiums deferred and uncollected and premiums due and unpaid are not properly accruable for the taxable year under section 809 and, accordingly, are not properly includible under assets (as defined in section 805(b)(4) for the taxable year, appropriate reduction shall be made in the life insurance reserves. This reduction shall be made when the insurance company has calculated life insurance reserves on the assumption that the premiums on all policies are paid annually or that all premiums due on or prior to the date of the annual statement have been paid.

(26 C.F.R. 1.801–4.)

* * * * *

Sec. 1.805–5. *Adjusted reserves rate and earnings rates.*

(a) ***In general.*** * * *

* * * * *

(4) ***Assets***—(i) ***Definition.*** Section 805(b)(4) defines the term "assets" as meaning all assets of the life insurance company (including nonadmitted assets), other than real and personal property (excluding money) used by the life insurance company in carrying on an insurance trade or business. * * *

* * * * *

Example (1). Included in the statement of assets of P, a life insurance company, are the following items: Bonds, stocks, mortgages, home office and branch office buildings owned and wholly occupied by the company, furniture and equipment owned by the company and used in the home office and branch office buildings occupied by the company, agents' debit balances, premiums deferred uncollected and premiums due and unpaid, bank deposits (including time deposits), and share accounts in savings and loan associations. For purposes of section 805(b)(4) and this subparagraph, the home office and branch office buildings owned and wholly occupied by the company, and the furniture and equipment owned by the company and used by it in connection with the operations conducted in the home office and branch office buildings occupied by the company, shall be excluded from the term "assets" since such items are the only ones considered as being used by P in carrying on an insurance trade or business. Accordingly, since bonds, stocks, mortgages, agents' debit balances, premiums deferred and uncollected and premiums due and unpaid, bank deposits (including time deposits), and share accounts in savings and loan associations are not considered as being used by P in carrying on an insurance trade or business, they are included within the term "assets" and, therefore, shall be taken into account by P in determining its current earnings rate.

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(26 C.F.R. 1.805–5.)

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